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C O N F I D E N T I A L SECTION 01 OF 02 BEIJING 002342

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SUBJECT: CHINA MONETARY POLICY UNCHANGED, BUT CREDIT FLOW SLOWS

REF: BEIJING 02284

Classified By: Acting DCM William Weinstein; Reasons 1.4 (b, d)

**¶1.** (C) Summary. China Banking Regulatory Commission (CBRC) Director General Han Mingzhi confirmed to the Acting DCM on August 12 that China will maintain its moderately easy monetary and proactive fiscal policies. At the same time, the CBRC must continue to serve as "watchdog" for the banking system, requiring the banks to improve vigilance and risk management and ensure bank lending is used for the real economy. Han said that in addition to improving their risk assessment and management capacities, banks also must improve financial services for underserved areas of central and western China. He agreed that small and medium (i.e., privately owned) enterprises sometimes lack adequate access to credit, although that situation is improving. Han also suggested that the U.S. and China, which share similar views on the timing and need for exit strategies from stimulus policies, should work together at the Pittsburgh Summit to convince the Europeans not to implement their own exit strategies too hastily. End summary.

#### Monetary Policy

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**¶2.** (C) During an August 12 courtesy call by the Acting DCM, China Banking Regulatory Commission (CBRC) Director General Han Mingzhi acknowledged the apparent contradiction between his agency's efforts to control bank lending, which seem to have resulted in a sharply reduced flow of new credit in July, and several recent high-level reaffirmations that China would "stay the course" of moderately easy monetary policy together with proactive fiscal policy (ref). Han said some other departments of the government want to boost the real economy, but the CBRC must fulfill its mission of "watchdog" for the banking system. To that end, it has instructed banks to "open their eyes wider" and be vigilant about lending risks, and to "re-check" their loan portfolios and borrower qualifications; Han observed that deferral of these checks until late 2009 or early 2010 might be too late. Similarly, the CBRC is seeking to ensure that bank lending is used for the real economy, rather than diverted to the stock market or real estate speculation, although loans for legitimate real estate investments are permitted. He said most banks have done well in this regard, but a small portion of lending may have been funneled through "indirect channels" for such unauthorized purposes.

**¶3.** (SBU) Note: Although not discussed in this meeting, in recent weeks CBRC has issued several new instructions to the banks concerning regulation of credit card business (July 16), second mortgages (July 23), fixed asset loans (July 27), project financing (July 27), and risk management for trading derivatives between banking institutions and institutional

clients (August 5). The intent and effect of these issuances has been to tighten regulator control of credit.

¶4. (SBU) Note, continued. Whatever the precise causes, after pumping out RMB 1.5 trillion in new lending in June and averaging RMB 1.2 trillion per month in the first half of 2009, China's banks have eased the flow of credit dramatically. July lending totaled just RMB 356 billion, a rate most analysts regard as appropriate and sustainable for the remainder of this year. To some extent, the lending numbers for this year are not abnormal, as bank lending in China usually is front-loaded to maximize bank interest earnings and also because most investment projects are approved early in the calendar year. Also, there was a particularly strong push by the government this year to finance projects under the fiscal stimulus program announced last November. That said, however, the aggregate amount of lending extended thus far in 2009 easily dwarfs any other year in recent history; the next largest half-year figure is RMB 2.544 trillion in 2007. End note.

Go West, Young Bankers

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¶5. (C) Han said China's banks face two major challenges. First, they must further improve their ability to assess and manage operational, credit, and market risks. In this respect, he believes bank capacity has increased enormously over the past 5-10 years, but more progress is needed. Second, the banks need to extend and improve financial services for small markets in underserved areas of central and western China, where the large banks have been reluctant to open branches. Han said the banks only want to serve

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people and businesses in the cities, not in rural areas: they collect deposits in small towns and rural areas, but then are reluctant to lend in those localities. Han said meeting this challenge is more important than even dealing with non-performing loans (NPLs) -- which also is important, although the NPL ratio has fallen to just 1.8 percent in 2009 -- because failure to address this need would leave financial reform incomplete.

¶6. (SBU) Note: CBRC recently posted statistics on its web site that support Han's assertion that rural areas have been underserved by banks, while also suggesting that the new emphasis on lending to those regions is taking root. For the first half of 2009, the top five provinces for new credit volume all are eastern and highly urbanized: Guangdong (RMB 855 billion), Jiangsu (753 billion), Zhejiang (636 billion), Beijing (564 billion), and Shandong (506 billion). On the other hand, when ranked by credit growth speed, four of the top five provinces are rural and/or western: Chongqing, Guangxi, Inner Mongolia, and Sichuan. End note.

SMEs vs. SOEs

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¶7. (C) Han said China's large banks have separate policies as well as credit quotas (approximately 20 percent of lending) for small and medium enterprises (SMEs) that cannot be transferred to state-owned enterprises (SOEs). He believes SME access to credit in coastal regions is not a serious problem, although some export-oriented companies have encountered short-term difficulties during the economic crisis. In smaller cities and in central regions, however, SMEs face difficulty obtaining bank loans because their creditworthiness is difficult for the banks to assess. As a consequence, they sometimes turn to the informal or underground banking systems to obtain credit; Han believes that system needs to be formalized, rather than banned, as it serves clients unable to obtain normal bank credit. The CBRC is encouraging large and small banks to establish separate departments to deal with SMEs.

Pittsburgh Summit

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¶ 8. (C) Han observed that the U.S. and China share similar views on the timing and need for exit strategies from ongoing economic stimulus policies. Accordingly, the two countries should work together and have a "strong voice" at the Pittsburgh Summit in September, in order to convince the Europeans not to implement their own exit strategies too hastily, lest they inadvertently ignite another economic and financial crisis. Han said CBRC Chairman Liu Mingkang intends to attend the summit, as does Minister of Finance Xie Xuren, People's Bank of China Governor Zhou Xiaochuan, and Minister of Foreign Affairs Yang Jiechi.

¶ 9. (C) Comment: The CBRC and China's other financial regulators are fighting against the tide, seeking to ensure that the push by senior and provincial leaders -- and most of the economic ministries -- for high GDP growth rates does not bring a return to the "bad old days" of the 1990s, when easy credit and government-directed lending created enormous problems in the banking system. After strong reforms, capacity building, and much improved management, that system -- as well as the regulatory structures and agencies -- now are vastly improved. At this time, there are no indications that serious credit leakage has occurred, although some diversion to the booming stock market and real estate speculation undoubtedly has slipped through. Inflation remains virtually non-existent. For NPLs, however, the huge volume of new lending has diluted the overall ratio for now, but the regulators understand that any problems in this area will not emerge for several years. End Comment.

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